

§ 1.904-7

26 CFR Ch. I (4-1-04 Edition)

Summary:

Total taxes deemed paid by P under section 960(a)(1) with respect to—		
Passive income of S and T included under section 951 in income of P:		
Line 5(a)	37.50	
Plus:		
Line 13(a)	0	
Plus:		
Line 13(c)	0	
Result	37.50	
General limitation income of S and T included under section 951 in income of P:		
Line 5(b)	6.25	
Plus:		
Line 13(b)	2.50	
Plus:		
Line 13(d)	1.25	
Result	10.00	
Total deemed paid taxes under section 960(a)(1)	47.50	
Total taxes deemed paid by P under section 902 and section 960(a)(3) attributable to passive income of S and T (line 15(e))		15.00
Total taxes deemed paid by P under section 902 and section 960(a)(3) attributable to general limitation income of S and T:		
Line 15(b)	7.50	
Plus:		
Line 15(d)	3.75	
Plus:		
Line 15(f)	2.50	
Result	13.75	

[T.D. 8214, 53 FR 27029, July 18, 1988, as amended by T.D. 8412, 57 FR 20652, May 14, 1992]

§ 1.904-7 Transition rules.

(a) *Characterization of distributions and section 951(a)(1) (A) (ii) and (iii) and (B) inclusions of earnings of a controlled foreign corporation accumulated in taxable years beginning before January 1, 1987, during taxable years of both the payor controlled foreign corporation and the recipient which begin after December 31, 1986—*(1) *Distributions and section 951(a)(1) (A) (ii) and (iii) and (B) inclusions.* Earnings accumulated in taxable years beginning before January 1, 1987, by a foreign corporation that was a controlled foreign corporation when such earnings were accumulated are characterized in that foreign corporation's hands under section 904(d)(1)(A) (separate limitation interest income) or section 904(d)(1)(E) (general limitation income) (prior to their amendment by the Tax Reform Act of 1986 (the Act)) after application of the de minimis rule of former section 904(d)(3)(C) (prior to its amendment by the Act). When, in a taxable year after the effective date of the Act, earnings and profits attributable to such income are distributed to, or included in the gross income of, a United States shareholder under section 951(a)(1) (A) (ii) or (iii) or (B) (hereinafter in this section "inclusions"), the ordering rules of section 904(d)(3)(D) and § 1.904-5(c)(4) shall be applied in determining initially the character of the income of the distributee or United States shareholder. Thus, a proportionate amount of a distribution described in this paragraph initially will be characterized as separate limitation interest income in the hands of the distributee based on the ratio of the separate limitation interest earnings and profits out of which the dividend was paid to the total earnings and profits out of which the dividend was paid. The distribution or inclusions must then be recharacterized in the hands of the distributee or United States shareholder on the basis of the following principles:

(i) Distributions and inclusions that initially are characterized as separate limitation interest income shall be treated as passive income;

(ii) Distributions and inclusions that initially are characterized as old general limitation income shall be treated as general limitation income, unless

the taxpayer establishes to the satisfaction of the Commissioner that the distribution or inclusion is attributable to:

(A) Earnings and profits accumulated with respect to shipping income, as defined in section 904(d)(2)(D) and § 1.904-4(f); or

(B) In the case of a financial services entity, earnings and profits accumulated with respect to financial services income, as defined in section 904(d)(2)(C)(ii) and § 1.904-4(e)(1); or

(C) Earnings and profits accumulated with respect to high withholding tax interest, as defined in section 904(d)(2)(B) and § 1.904-4(d).

(2) *Limitation on establishing the character of earnings and profits.* In order for a taxpayer to establish that distributions or inclusions that are attributable to general limitation earnings and profits of a particular taxable year beginning before January 1, 1987, are attributable to shipping, financial services or high withholding tax interest earnings and profits, the taxpayer must establish the amounts of foreign taxes paid or accrued with respect to income attributable to those earnings and profits that are to be treated as taxes paid or accrued with respect to shipping, financial services or high withholding tax interest income, as the case may be, under section 904(d)(2)(I). Conversely, in order for a taxpayer to establish the amounts of general limitation taxes paid or accrued in a taxable year beginning before January 1, 1987, that are to be treated as taxes paid or accrued with respect to shipping, financial services or high withholding tax interest income, as the case may be, the taxpayer must establish the amount of any distributions or inclusions that are attributable to shipping, financial services or high withholding tax interest earnings and profits. For purposes of establishing the amounts of general limitation taxes that are to be treated as taxes paid or accrued with respect to shipping, financial services or high withholding tax interest income, the principles of § 1.904-6 shall be applied.

(b) *Application of look-through rules to distributions (including deemed distributions) and payments by an entity to a recipient when one's taxable year begins be-*

fore January 1, 1987 and the other's taxable year begins after December 31, 1986—

(1) *In general.* This paragraph provides rules relating to the application of section 904(d)(3) to payments made by a controlled foreign corporation or other entity to which the look-through rules apply during its taxable year beginning after December 31, 1986, but received in a taxable year of the recipient beginning before January 1, 1987. The paragraph also provides rules relating to distributions (including deemed distributions) or payments made by a controlled foreign corporation to which section 904(d)(3) (as in effect before the Act) applies during its taxable year beginning before January 1, 1987, and received in a taxable year of the recipient beginning after December 31, 1986.

(2) *Payor of interest, rents, or royalties is subject to the Act and recipient is not subject to the Act.* If interest, rents, or royalties are paid or accrued on or after the start of the payor's first taxable year beginning on or after January 1, 1987, but prior to the start of the recipient's first taxable year beginning on or after January 1, 1987, such interest, rents, or royalties shall initially be characterized in accordance with section 904(d)(3) and § 1.904-5. To the extent that interest payments in the hands of the recipient are initially characterized as passive income under these rules, they will be treated as separate limitation interest in the hands of the recipient. To the extent that rents or royalties in the hands of the recipient are initially characterized as passive income under these rules, they will be recharacterized as general limitation income in the hands of the recipient.

(3) *Recipient of interest, rents, or royalties is subject to the Act and payor is not subject to the Act.* If interest, rents, or royalties are paid or accrued before the start of the payor's first taxable year beginning on or after January 1, 1987, but on or after the start of the recipient's first taxable year beginning after January 1, 1987, the income in the recipient's hands shall be initially characterized in accordance with former section 904(d)(3) (prior to its amendment by the Act). To the extent interest income is characterized as separate limitation interest income under these

rules, that income shall be recharacterized as passive income in the hands of the recipient. Rents or royalties will be characterized as general limitation income.

(4) *Recipient of dividends and subpart F inclusions is subject to the Act and payor is not subject to the Act.* If dividends are paid or accrued or section 951(a)(1) inclusions occur before the start of the first taxable year of a controlled foreign corporation beginning on or after January 1, 1987, but on or after the start of the first taxable year of the distributee or United States shareholder beginning on or after January 1, 1987, the dividends or section 951(a)(1) inclusions in the hands of the distributee or United States shareholder shall be initially characterized in accordance with former section 904(d)(3) (including the ordering rules of section 904(d)(3)(A)). Therefore, under former section 904(d)(3)(A), dividends are considered to be paid or derived first from earnings attributable to separate limitation interest income. To the extent the dividend or section 951(a)(1) inclusion is initially characterized under these rules as separate limitation interest income in the hands of the distributee or United States shareholder, the dividend or section 951(a)(1) inclusion shall be recharacterized as passive income in the hands of the distributee or United States shareholder. The portion, if any, of the dividend or section 951(a)(1) inclusion that is not characterized as passive income shall be characterized according to the rules in paragraph (a) of this section. Therefore, a taxpayer may establish that income that would otherwise be characterized as general limitation income is shipping or financial services income. Rules comparable to the rules contained in section 904(d)(2)(I) shall be applied for purposes of characterizing foreign taxes deemed paid with respect to distributions and section 951(a)(1) inclusions covered by this paragraph (b)(4).

(5) *Examples.* The following examples illustrate the application of this paragraph (b).

Example 1. P is a domestic corporation that is a fiscal year taxpayer (July 1-June 30). S, a controlled foreign corporation, is a wholly-owned subsidiary of P and has a calendar

taxable year. On June 1, 1987, S makes a \$100 interest payment to P. Because the payment is made after January 1, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) apply to characterize the payment made by S. To the extent, however, that the interest payment to P is allocable to passive income earned by S, the payment will be included in P's separate limitation for interest as provided in former section 904(d)(1)(A).

Example 2. P is a domestic corporation that is a calendar year taxpayer. S, a controlled foreign corporation, is a wholly-owned subsidiary of P and has a July 1-June 30 taxable year. On June 1, 1987, S makes a \$100 interest payment to P. Because the payment is made prior to July 1, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) do not apply. Assume that, under former section 904(d)(3), the interest payment would be characterized as separate limitation interest income. For purposes of determining P's foreign tax credit limitation, the interest payment will be passive income as provided in section 904(d)(1)(A).

Example 3. The facts are the same as in *Example 2* except that on June 1, 1987, S makes a \$100 dividend distribution to P. Because the dividend is paid prior to July 1, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) do not apply. Assume that, under former section 904(d)(3), S's earnings and profits for the taxable year ending June 30, 1987, consist of \$200 of earnings attributable to general limitation income and \$75 of earnings attributable to separate limitation interest income. The portion of the dividend that is attributable to S's separate limitation interest and is treated as separate limitation interest income under former section 904(d)(3) is \$75. The remaining \$25 of the dividend is treated as general limitation income under former section 904(d)(3). For purposes of determining P's foreign tax credit limitation, \$75 of the dividend will be recharacterized as passive income. The remaining \$25 of the dividend will be characterized as general limitation income, unless P can establish that the general limitation portion is attributable to shipping or financial services income.

(c) *Installment sales.* If income is received or accrued by any person on or after the effective date of the Act (as applied to such person) that is attributable to a disposition of property by such person with regard to which section 453 or section 453A applies (installment sale treatment), and the disposition occurred prior to the effective date of the Act, that income shall be

characterized according to the rules of §§ 1.904-4 through 1.904-7.

(d) *Special effective date for high withholding tax interest earned by persons with respect to qualified loans described in section 1201(e)(2) of the Act.* For purposes of characterizing interest received or accrued by any person, the definition of high withholding tax interest in § 1.904-4(d) shall apply to taxable years beginning after December 31, 1986, except as provided in section 1201(e)(2) of the Act.

(e) *Treatment of certain recapture income.* Except as otherwise provided, if income is subject to recapture under section 585(c), the income shall be general limitation income. If the income is recaptured by a taxpayer that is a financial services entity, the entity may treat the income as financial services income if the taxpayer establishes to the satisfaction of the Secretary that the deduction to which the recapture amount is attributable is allocable to financial services income. If the taxpayer establishes to the satisfaction of the Secretary that the deduction to which the recapture amount is attributable is allocable to high-withholding tax interest income, the taxpayer may treat the income as high-withholding tax interest.

[T.D. 8214, 53 FR 27034, July 18, 1988, as amended by T.D. 8412, 57 FR 20653, May 14, 1992]

§ 1.904(b)-1 Treatment of capital gains for corporations.

(a) *In general.* For purposes of computing the foreign tax credit limitation of corporations, the following rules apply:

(1) *Inclusion in foreign source taxable income.* The taxable income of a corporation from sources without the United States includes gain from the sale or exchange of capital assets only in an amount equal to—

(i) Foreign source capital gain net income (as defined in paragraph (b)(2) of this section), reduced by

(ii) The rate differential portion (as defined in paragraph (b)(5) of this section) of foreign source net capital gain (as defined in paragraph (b)(4) of this section).

(2) *Inclusion in entire taxable income.* The entire taxable income of a corpora-

tion includes gain from the sale or exchange of capital assets only in an amount equal to—

(i) Capital gain net income (as defined in paragraph (b)(1) of this section), reduced by

(ii) The rate differential portion of net capital gain (as defined in paragraph (b)(3) of this section).

(3) *Treatment of capital losses.* The taxable income of a corporation from sources without the United States shall be reduced by an amount equal to—

(i) Any net capital loss (as defined in paragraph (b)(6) of this section) allocable or apportionable to sources without the United States to the extent taken into account in determining capital gain net income for the taxable year, less

(ii) An amount equal to the rate differential portion of the excess of net capital gain from sources within the United States over net capital gain (from all sources).

(b) *Definitions.* For purposes of section 904(b) and §§ 1.904(b)-1 through (b)-3, the following definitions shall apply:

(1) *Capital gain net income.* The term *capital gain net income* means the excess of the gains from the sales or exchanges of capital assets over the losses from such sales or exchanges. Such term shall include net section 1231 gain, but shall not include gains from the sale or exchange of capital assets to the extent that such gains are not treated as capital gains. In determining capital gain net income, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(2) *Foreign source capital gain net income.* The term *foreign source capital gain net income* means the lesser of—

(i) Capital gain net income from sources without the United States, or

(ii) Capital gain net income (from all sources).

(3) *Net capital gain.* The term *net capital gain* means the excess of the net long-term capital gain (including net section 1231 gain) for the taxable year over the net short-term capital loss for such year, but shall not include gains